Ninth Circuit Rules Against PACE Proponents; Texas Bill Shows Way Forward

Jeremy Brown March 22, 2013

Back in December, we blogged about PACE litigation and predicted that the sole court that sided with challengers to a federal rule limiting PACE-financing on residential real estate – the Northern District of California – would be overturned. This week, the Ninth Circuit did just that, snuffing any short-term hopes that may have remained for broad-scale PACE residential programs.

Our previous post recounted the legal saga of PACE financing. In brief, environmental NGOs (and the renewable energy and energy efficiency industries) have claimed that PACE can reduce carbon emissions and other ills by providing a source of capital and a suite of solutions to the market barriers that discourage property owners from investing in improvements like solar panels and improved insulation.

The rub is that PACE financings are structured as voluntary property tax assessments and secure debt with property liens that are superior to all private liens, including mortgages. As a result, the mortgage industry claims PACE liens increase risks to mortgage holders and diminish the value of mortgage liens.

In 2010, the Federal Housing Finance Agency (FHFA) issued a directive instructing Fannie Mae and Freddie Mac not to purchase mortgages on properties encumbered with PACE debt. Since Fannie Mae and Freddie Mac securitize almost all residential mortgages, the directive effectively chilled residential PACE financing.

In several jurisdictions, local governments with PACE programs and environmental NGOs sued the FHFA, alleging the agency failed to comply with the Administrative Procedure Act (APA). These cases turned on the somewhat esoteric issue of whether FHFA was acting as a regulator or a conservator of Fannie Mae and Freddie Mac when it issued the directive.

All courts except the Northern District found that the FHFA has acted as a conservator and could issue the directive without complying with APA rulemaking requirements. The Northern District, however, held that the FHFA had acted as a regulator and ordered the agency to undertake a formal rulemaking.

The Ninth Circuit reached a contrary conclusion and vacated the district court decision; the FHA can probably now abandon its rulemaking. (The FHFA had proposed an initial rule that was similar to the directive and the final rule surely would have been as well; but the rulemaking itself could have exposed the agency to further litigation from aggrieved parties.)

In Texas, meanwhile, PACE enabling legislation – SB 385, sponsored by Dallas senator John Carona – is steadily moving forward. The bill would amend PACE statutes that have been on the books since 2009 but have not led to any operational PACE programs.

SB 385 would make Texas one of the first states in the country to allow PACE financing for energy *and* water conservation improvements. It would permit PACE financing only for residential, industrial and multifamily properties, meaning it could dodge the concerns of the residential mortgage industry concerns and the FHFA directive. What is more, while the bill would preserve the seniority of PACE liens, it would require that prospective PACE borrowers obtain prior consent from their mortgage holders.

This balanced approach respects the value of PACE as a financing mechanism and the concerns of the mortgage industry. It enables industrial and commercial properties – which may use substantial amounts of energy and water – to reduce their environmental impacts. And it should be seen as model for other states that wish to work within the constraints imposed by the FHFA but continue to reap the benefits of PACE.

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